

# Convergence on Governance Issues, Dissent on Economic Policies

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IDS Bulletin Vol 29 No 2 1998

## 1 Introduction

'Without it [the state], sustainable development . . . is impossible. . . . the state is central to economic and social development, not as direct provider of growth but as a partner, catalyst and facilitator' (WDR97, p.1, fourth para). In a way, this emphatic statement – which recurs in one form or another throughout the Report – best summarises the main message of WDR97, and the 'new role' this assigns to the state. In the same vein, the Report underscores the close complementarity, rather than the alleged antagonism, existing between state and market, and the need for reinvigorating the state's institutional capacity as a way to promote development. The WDR97 thus accepts that the 'over-withdrawal of the state' observed during the last two decades in Sub-Saharan Africa, Latin America, Eastern Europe, the former Soviet Union and Vietnam, has slowed down the creation of human capital, reduced the political sustainability of growth and harmed social and economic development.

WDR97 strives to be a consensus document. In a sense it attempts to reconcile the 'Washington consensus' (which assumes a 'residual state') with the 'East Asian model' (which presupposes a 'developmental state'). Because of this attempt, it generally abstains from a dogmatic blueprint approach. This leaves room for diversity of state responses even if, at times, this makes the Report similar to a nice homily that does not offer precise directions for action. This is, however, a lesser evil than the over-prescriptive approach typical of earlier Bank documents.

Thus, gone are the days of the 'anti-state' tone of earlier World Bank publications inspired by the New Political Economy (NPE). While it is difficult to assess the influence that World Development Reports have on the Bank's policies and operations – the situation is likely to be a mixed one – and while 'the proof of the pudding is in the eating', it is quite possible that the change of tone of WDR97 signals the emergence of a new policy stand. If the message of the Report will percolate, if only in part, into the real world of World Bank operations, its

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<sup>1</sup> I would like to thank Tony Addison, Dag Ehrenpreis, Mick Moore, Germano Mwabu and Gordon White for comments on an earlier version of this article.

impact on policy framework papers, Country Assistance Strategies, and sectoral programmes will undoubtedly be considerable. This will be all the more the case when comparing the new approach with the NPE-inspired reforms dominating the policy agenda until recently. NPE basically entailed:

- a sharp downsizing of the state, extensive deregulation and rapid privatisation of state assets. Privatisation was to involve not only enterprises producing private goods, but also institutions providing public goods, merit goods, and goods with large externalities
- the large-scale introduction of user fees in health and education establishments that could not be privatised, and the opening up of these markets to the private initiative
- reliance on churches and charities to tackle poverty and exclusion
- cuts in tax ratios and the progressivity of taxation (even in countries affected by large income inequalities) on account of the efficiency costs taxes allegedly impose on the economy. This implied cuts in public expenditure (in addition to those dictated by macro-economic reasons).

Thus, there are genuine reasons to appreciate the refreshing tone of WDR97, and to restate a faith in the usefulness of the long-standing dialogue between the World Bank and its critics. Yet, not everything is new and uncontroversial in the Report. The definition of the long-term role of the state is reductionist. There are also problems with the part of the Report which discusses 'good policies' (on which, despite their 'goodness', there is little consensus and much more needs to be known – as indicated by the recent crisis of the East and South East Asian economies, which, by everybody's judgement, had very strong fundamentals). In this area, few changes from the orthodoxy are evident in WDR97.

For instance, privatisation is presented as inevitably efficiency enhancing (in spite of the moral hazard caused by insider privatisation in the economies in transition), while trade liberalisation is seen as a source of economic growth for all, and foreign direct investment and portfolio flows are seen as main contributors to higher savings and growth rates, despite their potential for causing acute macro-instability, as the recent Asian events

demonstrate. And so on. In addition, the impact of the spread of information technology, and therefore the importance of technical and scientific education, one of the driving forces of globalisation, is ignored. There is no discussion of frontier governance issues, e.g. the way state action is being constrained by the globalisation of capital and the rising power of transnational corporations. This persistent dogmatism is dangerous. Even the major improvements in state institutions suggested in WDR97 risk generating only modest results, if the basic policymaking framework remains unaltered.

I will mainly focus my remarks on the above issues. Before doing so, however, I would like to highlight areas of convergence I have identified in the Report.

## 2 Areas of Convergence and Dilemmas

In the field of social policy, WDR97 marks an improvement over many of the World Bank's past statements. While not everything is new or can be agreed upon, a refreshing tone dominates the discussion, and practical suggestions are made on a number of policy and governance problems.

### (i) Social policy

The Report makes several interesting points concerning the focus and content of policy, and the approach to service delivery. Among these, the following are worth noting:

- WDR97 acknowledges that recent reforms have emphasised economic fundamentals to the detriment of the social and institutional basis needed to ensure the success of reforms. Greater emphasis is now placed on the 'ownership of reforms' and on a political economy which emphasises consultation, negotiation, and compensation.
- while proposing 'new welfare mixes', in which state, market and civil society all play a role, the Report emphasises the central role of the state in service financing, overall guidance, and performance monitoring.
- the Report underscores the need for correcting inter- and intra-sectoral biases in the allocation of public expenditure. While the point is not new, to the best of my knowledge, few concrete changes have taken place so far in this area. Perhaps, with the new impetus provided by

WDR97, budget restructuring will start in earnest in the years ahead.

- the Report (p.87) takes a prudent and nuanced position when discussing the introduction of market surrogates, subcontracting and competition (along the lines of the 'new public management' reforms introduced, for instance, in New Zealand). It highlights, in particular, the limitations of this approach in countries with a shortage of regulatory skills. At the same time, the Report downplays the difficulties involved – even in richer countries – in regulating privatised utilities and in striking deals (as in the case of privatisation of water and sanitation, transport and power) which are friendly to the poor and the environment.

## **(ii) Approach to governance issues**

This is the area where WDR97 probably makes the strongest points:

- the discussion of the measures proposed to enhance state capability (judicial independence, watchdog bodies, merit-based recruitment, decentralisation, involvement of the civil society in service delivery, deliberation councils, client surveys, managed competition, subcontracting and so on) is innovative and realistic. No pre-packaged solutions are imposed on the reader or the policymaker.
- in the field of citizens' and NGOs' participation in policy-making and service delivery, the former 'technocratic approach' is replaced by one which emphasises consultation, partnership and co-production. While the participation of communities and NGOs is strongly advocated, the dangers of fragmentation, capture by local interests, gap in service standards, and overall lack of resources (i.e. problems inherent to an 'NGO-option') are also underscored.
- the discussion of the pros and cons of decentralisation is particularly good. WDR97 makes it clear that, while decentralisation has many advantages, its success critically hinges on a strong central government, the existence of clear intergovernmental rules and transfer systems which avoid disincentive and moral hazard problems, the mobilisation of local resources, and the introduction of fiscal equalisation mechanisms.

- when discussing the reform of the civil service, the Report abandons the traditional World Bank position (reduce the number of employees on the payroll and raise the pay of top civil servants) and rightly emphasises meritocratic recruitment, adequate pay for all, *esprit de corp*, autonomy from political interference, capacity to formulate policy, and greater accountability vis-à-vis the supervisors and the service users. However, while the analysis focuses on positive incentives, it does not go far enough in discussing sanctions. It does not discuss, for instance, the nature of employment contracts in the civil service, the legal responsibility of top civil servants, and so on.

## **(iii) An eclectic theoretical approach**

An interesting aspect of WDR97 is the relative novelty of its theoretical approach:

- eclecticism is the term which best describes the analytical approach dominating the Report. While the combination of ideas originating from different schools of thought may, at times, leave the reader confused, it prevents providing a false unitary doctrinal perspective on the role of the state.
- a second element of novelty concerns the shift from the NPE-inspired 'sceptical view of the state' to a serious analysis of institutions inspired by the New Institutional Economics (NIE) (Lin and Nugent 1995). The shift to NIE is, however, incomplete. Indeed, the Report emphasises primarily the role of formal institutions (well functioning legal systems that allow the rules of the game to be swiftly enforced). Yet, until recently, in East Asia and other fast growing economies formal legal systems have been little developed (a fact that, however, might have contributed to the recent financial instability in the Asian region). Thus, in a sense, WDR97 neglects the fact that the development of a complete set of formal institutions is costly, and that, historically, informal social norms have served as a surrogate to lower transaction costs. In the Report, there is also a limited discussion of the relation between informal rules and formal institutions, and of the way informal institutions evolve. These topics could have received greater attention, as the development of formal rules is no guarantee of their automatic enforcement.

### 3 Areas of Persistent Dissent

As noted in the introduction, WDR97 takes a dogmatic stance on a number of key economic policies, adopts a reductive definition of the role of the state, and says little about the impact and governance implications of globalisation.

#### (i) A reductionist view of the role of the state in promoting equity

A few words are conspicuously underemphasised in the Report: these are 'equity', 'redistribution', and 'equal opportunities'. While Table 1.1 (which defines the functions of the state) includes asset redistribution as a possible focus of state action (for well-managed and activist states only, however), the subsequent discussion (pp.54–59) deals only with measures (better sectoral allocation of public expenditure, investment in health and education and anti-poverty programmes) that focus on poverty alleviation and, to a lesser degree, on the improvement of the final distribution of income. The Report says nothing about the need to offer **'broadly equal economic opportunities to all'**. This can be (and has been) achieved by redistributing assets, increasing access to markets, skills and credit, and by removing those cultural biases (starting from the gender bias) which exclude large number of citizens from the production and exchange process.

The vacillations of WDR97 in dealing with this issue are surprising, as the literature (including a recent World Bank report highlighting the rise of inequality in Asia) has amply discussed both the social and moral value of offering equal opportunities to all, and the economic advantages deriving from the incorporation of all willing citizens in the production process. Providing equal economic opportunities helps to create 'a democratic market' (an essential component of overall democracy), improves the legitimacy of the state, and the sense of stakeholding in the population at large. Recent analyses show that states affected by severe income and asset concentration are considered illegitimate by their citizens, face higher risks of social unrest and armed conflicts (as in the case of Central America), are less likely to adopt economic reforms, and eventually impose large costs on the international community – and on the World Bank itself – on occasion of their collapse.

While implementation of redistributive reforms might entail important or even radical political implications that might be resisted by the ruling elites, there are encouraging signs of change along these lines in parts of Latin America and East Asia.

#### (ii) Ambivalence on taxation

In many developing countries (since the early 1980s) and transitional economies (since 1989), the crisis of the state was triggered by sharp falls in discretionary public expenditures following the introduction of stringent fiscal adjustment programmes. Surprisingly, WDR97 ignores this factor. In countries affected by a severe crisis of the state, the recovery of growth entails a reversal of the decline in public expenditure, a point also made by the Report. Yet, while WDR97 underscores the need for improved tax collection (and goes as far as suggesting the 'enclaving on a priority basis' of the reform of the ministries of finance), it is silent about the need to increase tax ratios and, in some cases, tax rates. For instance, several of the growth and equity problems faced by Russia depend on the unwillingness of its central government (which collects a paltry 8 per cent of GDP) to tax large corporations and the informal sector. The result of this situation is that individual rights are unprotectable, unless the state recovers a minimum power to tax and spend (Holmes 1997). Similarly, neglect of revenue collection in the 'first generation' stabilisation programmes led to the fall of tax ratios in many sub-Saharan African countries in the 1980s.

Thus, the WDR97 should have emphasised that an efficient reform of the state will often require a tax policy which is more pro-active, decentralised and with strong anti-corruption provisions. Such a policy should aim at improving revenue generation and enhancing the transparency, efficiency and equity of the tax system (Cornia and Mwabu 1997). A non-distortionary increase in tax ratios of 1–2 points of GDP is technically feasible even in the low income countries of Sub-Saharan Africa. In Chile, revenue was raised by about 2 percentage points of GDP in the 1990s by means of an income tax surcharge and a temporary increase in the VAT (Schkolnik 1992).

There are also external reasons for improving revenue collection in developing countries. Aid donors are, in fact, increasingly anxious to see recipient

countries mobilise their resources to reduce aid dependency. And taxpayers in donor countries are increasingly reluctant to provide foreign aid to those countries where tax evasion remains extensive.

### **(iii) Asymmetric treatment of market and state failures**

'Matching role to capability' means that when state capabilities are weak, one should increasingly lean towards liberalisation and deregulation. On closer look, this statement is less attractive than at first sight. While it is obvious that the state (or anybody else) should not bite off more than it can chew, leaving to the market all activities the state is unable to manage is no guarantee of successful development. Where states are weak, markets also are often weak (i.e. incomplete, missing, thin, asymmetrically informed, etc.). The Report seems to underestimate the difficulties encountered in establishing genuinely competitive markets in poor countries with soft states.

For instance, subcontracting the delivery of health, education, and other services to private providers is a reasonable option; if private providers are efficient, markets are competitive, the state is able to regulate and control them, and so on. The greater micro-economic efficiency of private providers implicitly assumed by WDR97 is not always borne out by the evidence. Even in developed countries, such as the UK, there have been considerable difficulties in executing health care reform. In some cases 'weak markets are even weaker than weak states', as in the case of health and education in Kenya, vaccination services in Somalia, and so on. For instance, a recent review of the education sector in low-income countries (Appleton 1997) comes to the conclusion that while privatisation and vouchers-based strategies could have been attempted, the most promising approach consisted in strengthening the state sector and its finances.

### **(iv) Uncritical discussion of orthodox economic policies**

Despite the frequent failure of orthodox policy reform in sub-Saharan Africa and Eastern Europe, in WDR97, the basic recipe for reform (deregulation, privatisation and liberalisation) remains unchanged and unquestioned. While overall economic policy reform is not the focus of the Report,

the lack of evolution of the orthodox positions in this area contrasts sharply with the more nuanced and articulated position taken when discussing decentralisation, the role of NGOs, and so on. Among the 'good policies' discussed in the Report:

- Privatisation is presented as a universal panacea. WDR97 rightly emphasises the benefits of clear and stable property rights, and the importance of state action in defending them firmly. While the Report recognises that strengthening communal property rights systems may be the best option in certain settings (as in many parts of Africa), it generally considers the rapid establishment of private property rights the best way to reduce transaction costs and bring about growth. This ignores the lessons of the recent large-scale privatisations of Eastern Europe and the former Soviet Union, where in many cases insider and give-away privatisations have caused severe incentive, moral hazard and governance problems. The Report equally ignores the remarkable efficiency of economic entities (such as the Chinese town and village enterprises or the Italian co-operatives) operating under property rights regimes different from the private one.
- Trade liberalisation is presented as a necessary measure for the improvement of economic performance. However, despite rapid liberalisation, 93 countries (mainly located in Africa, Latin America and the Middle East) continue to experience major difficulties in penetrating world markets while, at the same time, experiencing rapid de-industrialisation at home. As underlined by the new trade theory, their ability to compete in the international market depends more on the ability to generate dynamic comparative advantages (requiring time, a broad industrial policy, investments in skills, the creation of public/private technological networks, and investment in infrastructure and general education) than on the simple opening up of the domestic market and a competitive exchange rate. What trade policy should be adopted in countries where these conditions are not met?
- Financial liberalisation is expected to attract foreign capital (both foreign direct investment and portfolio flows), and thus to increase financial intermediation and deepening, savings, investment, the absorption of new technology and

growth. There is only limited mention of the distortions of the exchange and interest rates which may derive (even under conditions of moderate macro imbalance) from the liberalisation of portfolio investments. Little is also said about the increased volatility, and its impact on the real economy, that uncontrolled portfolio flows can cause. The remedies proposed (p.135) are mainly domestic and include tight monetary, fiscal and exchange rate policies (even if these are known to have a deflationary bias), prudential regulation of the banking sector, and the upgrading of national regulatory frameworks. Little is said about the systemic regulation of these flows by the International Monetary Fund, the Bank for International Settlements, and so on (Griffith Jones 1997).

- In contrast, the position of WDR97 on deregulation is broadly acceptable: the Report concludes that market efficiency is not the result of 'laissez faire' but of skilful regulation. It makes a strong case for regulation of the banking sector, the utilities and the environment (good government is essential, for instance, to mediate between the interests of current and future generations in the use of environmental resources). This change of perspective is all the more welcome in view of the narrow interpretation of deregulation prevailing so far, a fact which might help explain the limited impact of economic reforms in many developing and transitional economies.

#### **(v) Limited focus on globalisation and the ability of national governments to conduct an independent economic policy**

Chapter 8 of WDR97 is dedicated to international collective action and to the provision and funding of international public goods. Particularly in view of the title of the Report ('The State in a **Changing World**', emphasis added) it might have been useful to discuss more extensively the changes entailed by globalisation (the extent and causation of which are still poorly understood) and the international measures that might be introduced to guide this tumultuous process and to deal with its negative aspects. However, in the Report, little is said on both points.

Deficiencies are particularly evident in:

- The inadequate treatment of the impact of globalisation. Little is known about the impact of external liberalisation in countries with limited human capital, infrastructure and resource base. Initial evidence (generated by the Bank itself in 1991) points to positive effects for the middle and higher income countries and negative ones for the low income, small, ones. There are also suggestions that both global and country-specific inequality is rising as a result of globalisation. Lastly, globalisation seems to increase external vulnerability and growth volatility in economies with poorly diversified economic structures. As many poor developing countries are already strongly trade dependent, it is important to pay more attention to these issues, and to the responses that the new situation warrants,
- A puzzling aspect of the Report is the neglect of the national and international impact of information technology, possibly the most dynamic component of globalisation. The spread of this and other technologies in countries with abundant labour supply can have a distorting effect on income distribution, consumption patterns and social exclusion. The impact on growth remains uncertain, while the governance implications of these changes are potentially serious. Thus, should government and international authorities promote in an unfettered way the diffusion of this technology?
- Frontier domestic and international governance issues are dealt with only tangentially. There is no discussion of the way state actions are being increasingly constrained by the globalisation of capital and the increase in the power of transnational corporations and financial intermediaries (treated in the Report as engines of growth and not as political actors). Little attention is thus paid to the shift in power balances, decision-making and political economy following globalisation. Finally, precious little is said about the implications for international governance and the inadequacy of current international structures in the age of fast globalisation.

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